Agricultural Economics 330
Fall 2012
Exam I

1. List 3 uses for each of the financial statements listed below. (14 points)
   a. Balance Sheet  \(1.5\) points for each answer
      see the attached lists of potential uses
   b. Accrual Basis Income Statement
   c. Cash Flow Budget

2. When analyzing a farm or ranch business, why is it insightful to determine its net worth (owner equity) on both a cost and a market value basis? (5 points)

   to be able to determine how much of the business' net worth is the result of reinvested earnings or contributed capital and how much is the result of changes in asset values

   they don't need to say this, but the difference between market value net worth and cost basis net worth represents valuation equity (can be + or -)
USES OF A BALANCE SHEET

1. Tell you how much you’re worth; that is, how much would be left if all your assets were sold and your debts were paid off.

2. Tell you something about your ability to bear risk; that is, how serious the effect of an unexpected loss would be.

3. Show what collateral you have available to secure loans.

4. Provide values of year-end inventories which are essential in order to accurately measure profitability on the income statement.

5. Provide year-to-year comparative information to indicate trends in the financial position and financial structure of the business.

6. Provide information to use in estate planning.

7. Allow you to see, when used in conjunction with the income statement, how much of the change in financial position is due to reinvested earnings (losses), how much is due to inflation (deflation) in asset values.
USES OF AN ACCRUAL BASIS INCOME STATEMENT

1. Determine the actual Profit or Loss generated by the business during a specific period of time by matching Revenues and Expenses with the period.

2. Avoids the possible distortion created by Cash Basis Income statements. Cash Basis Accounting can result in a lag of several years before losses are recognized.

3. Help analyze the contributions of different enterprises to the Profitability (or the Losses) of the business.

4. Determine your true Cost of Production.

5. Provides a tool for evaluating operating efficiency on an economic basis.

6. A knowledge of Net Income is crucial for analyzing Investment Decisions and Capital Debt repayment capacity.

7. Can be used in conjunction with the Balance Sheet to determine how much of the change in financial position is due to Reinvested Earnings (Losses) and how much is due to Inflation (Deflation).
USES OF THE CASH FLOW BUDGET

1. Provides the best Measure of Liquidity -- Your ability to meet financial obligations as they become due without disrupting the continuing operation of your business.

2. Used as a Projected Statement -- It helps you formalize the overall planning process.


4. Serves as a Financial Control Tool -- By allowing you to monitor Actual Performance versus Budget Projections.

5. Formalizes the process of Integrating Plans and Objectives for the various enterprises within the business.

6. Directs attention to the Management of Cash Reserves.

7. By allowing you to formulate projection estimates for several alternative outcomes, it provides a practical tool for analyzing the Impact of Risk (Uncertainty).

8. Helps you assess the relationships among your Production, Marketing and Financing plans.

9. As an Investment Analysis Tool -- Compare cash flows projected under current operations and modified operations.
3. A business can be a) generating a positive cash flow and be unprofitable and b) be profitable but experiencing cash flow problems. For a) and b) give me 3 examples of how/why each statement is true. (10 points)

1 point for each example

a) non-farm income
   borrowing
   selling assets (including inventory)
   receiving gifts or inheritances
   building accounts payable
   accruing expenses
   writing off depreciation

b) improperly structured debt
   building inventories
   building receivables
   buying assets
   living on more than the business is earning
   giving gifts
   paying off debt too fast
4. The discussion of financial statement analysis was built around 5 financial criteria that are used to evaluate a business's financial position and performance. List them (you don't need to define) and for each name 2 financial measures used to evaluate that criteria (you don't need to show how to calculate) (20 points)

- Liquidity

- Solvency

- Profitability

- Repayment capacity

- Financial efficiency

2 points for each criteria
1 point for each measure (see attached list of possible measures)

5. What creates the deferred taxes liability on current assets (5 points)

Results from the difference in timing of recognizing revenues and expenses when using one accounting measure for financial reporting and another for tax reporting

or: the tax that would result if all current assets were sold and all current liabilities were paid
FINANCIAL MEASURES

Liquidity
• Current Ratio
• Working Capital
• Working Capital to Gross Revenues
• Cash Flow Coverage Ratio
• Budgeting Error

Solvency
• Farm Debt-to-Asset Ratio
• Farm Equity-to-Asset Ratio
• Farm Debt-to-Equity Ratio
FINANCIAL MEASURES

Profitability
- Rate of Return on Farm Assets
- Rate of Return on Farm Equity
- Operating Profit Margin
- EBITDA

Repayment Capacity
- Capital Debt Repayment Capacity
- Capital Debt Repayment Margin
- Term-Debt Coverage Ratio
- Farm Debt-to-Income Ratio
Financial Measures

Financial Efficiency

- Asset Turnover Rate
- Operating Expense Ratio
- Depreciation Expense Ratio
- Interest Expense Ratio
- Net Farm Income Ratio
- Average Collection Period
- Average Days Payable
- Days Inventory
- Inventory Turnover
- Labor Productivity
- Machinery & Equipment Productivity
6. If a business is using borrowed money profitably will its rate of return on equity (ROE) be higher or lower than its rate of return on assets (ROA) and why? (5 points)

2.5 points
ROE would be higher than ROA.

2.5 points
Either/or
- If borrowed capital is being used profitably, it means that the return of borrowed capital exceeds its cost and the excess returns increase the return on equity.
- If borrowed capital is not being used profitably, it means that the return of borrowed capital is less than what is paid for it.

7. I went over 5 reasons why farmer and ranchers (or any business owner) should do financial statement analysis as a way to improve their decision making. Identify 4 of them. (6 points) 1.5 points each (only need 4 of the following)

- Identify and learn from the results of past decisions (i.e. mistakes)
- Make fewer mistakes
- Identify strengths and weaknesses
- Not opportunities
- Take more timely and appropriate action to correct the mistakes (or problems that arise) that are made

8. What do you get if you multiply a business’s operating profit margin by its asset turnover ratio? (5 points)

\[
\text{ROA return on assets} = \frac{\text{NI} + \text{interest}}{\text{GR}} \times \frac{\text{GR}}{\text{TA}} = \frac{\text{NI} + \text{interest}}{\text{TA}} = \text{ROA}
\]

-3 if they say ROE
9. On the proposed federal budget for 2012 that I went over in class, 5 expenditure categories made up approximately two-thirds of the budget. At that time, even if every other federal program was eliminated, we would have still been operating at a deficit. What were those 5 expenditure categories? (5 points) 1 point each
   - social security (and federal retirement)
   - medicare
   - medicaid
   - defense
   - interest on the federal debt

10. The current federal debt is over $16 trillion dollars. If interest rates returned to their historic averages and went up by 4 percent, how much would it add to the annual cost of servicing the federal debt? (5 points)

   \[ \times 640 \text{ billion} \]
   \[ \frac{16,000,000,000,000 \times 0.04}{640,000,000,000,000} \]

   -1 for arithmetic mistake
   -2.5 if they say million rather than billion
11. Calculate the cash basis net farm income and the accrual adjusted net farm income for 2012 for John Ellis’ Farms, a proprietorship. (20 points)

1. Cash sales of feeder calves $250,000
2. Cash sales of cotton 1,200,000
3. Cash received for custom combining 25,000
4. Cash rent paid 64,000
5. Cash purchases of seed, chemicals, fertilizer, fuel 850,000
6. Principal payments on farm mortgage 50,000
7. Interest paid on all loans 100,000
8. Wages paid to hired labor 90,000
9. Sale of 80 acres 200,000
10. Purchase of new planter on 2/1/12 $120,000
11. Government payments received 80,000
12. Cotton inventory 12/31/11 360,000
13. Cotton inventory 12/31/12 0
14. Accounts receivable 12/31/11 60,000
15. Accounts payable 12/31/11 60,000
16. Increase in supplies inventory from the beginning to the end of the year 40,000
17. Cash sales of wheat 200,000
18. Depreciation expense 75,000
19. Family living withdrawals 60,000
20. Increase in value of owned land 96,000
21. Accounts receivable 12/31/12 0
22. Accounts payable 12/31/12 40,000
23. Accrued interest payable 12/31/11 30,000
24. Accrued interest payable 12/31/12 20,000
25. Basis (book value) of land sold in #9 64,000

\[
\begin{align*}
\text{Cash revenue:} & \quad \text{Cotton sales} \quad 1,200,000 \\
& \quad \text{Custom combining} \quad 25,000 \\
& \quad \text{Goverment payments} \quad 80,000 \\
& \quad \text{Wheat sales} \quad 200,000 \\
& \quad \text{Gain on land sale} \quad 136,000 \quad (200,000 - 64,000) \\
\text{Cash revenue} & \quad 1,891,000 \\
\text{Cash expenses:} & \quad \text{Cash rent} \quad 64,000 \\
& \quad \text{Acreage} \quad 852,000 \\
& \quad \text{Interest} \quad 100,000 \\
& \quad \text{Depreciation} \quad 75,000 \\
& \quad \text{Cash expenses} \quad 1,179,000 \\
\text{Cash NFI} & \quad 712,000 \\
\text{Accrual adjustment} & \quad -350,000 \\
\text{Accrual NFI} & \quad 362,000
\end{align*}
\]
Agricultural Economics 330  
Fall 2013  
Exam 1

1. A business can be a) unprofitable but generating a positive cash flow and b) profitable but experiencing cash flow problems. For a) and b) give me 3 examples of how each statement can be true. (6 points)

   a) any 3 of the following 1 point each
      accruing expenses
      non-farm income
      building accounts payable
      borrowing or refinancing
      selling off assets (includes selling inventory)
      receiving gifts or inheritances

   b) any 3 of the following 1 point each
      paying off debts too fast
      pay accounts payable
      building inventory
      building receivables
      cash purchases of assets
      giving gifts of money
      living on more than the business makes

2. I gave you 5 ways that decision making can be improved through more effective financial planning and analysis. What were 3 of them? (6 points)

   3 of the following 2 points each
   learn from mistakes
   make fewer mistakes
   take more timely and appropriate action
   identify strengths and weaknesses
   spot opportunities
3. What creates deferred taxes on current assets? (6 points)

Deferred taxes result from the difference in timing of income recognition when one accounting method is used for financial reporting and another for tax reporting.

Also acceptable: the taxes that would result from selling all current assets and paying all current liabilities.

4. What is the primary reason for having a balance sheet that shows net worth (owner equity) on both a cost and a market value basis? (6 points)

To see how much of net worth is due to capital contributions and retained earnings, and how much is due to market value changes.

5. What financial measure do you get if you multiply a business's operating profit margin by its asset turnover ratio? (6 points)

\[
\text{ROA (return on assets)} = \frac{\text{Net income for operations + interest}}{\text{Gross revenue}} \times \frac{\text{Gross revenue}}{\text{Total assets}} = \frac{\text{Net income from operations + interest}}{\text{Total assets}} \times \text{ROA}
\]

-3 if they say ROE (return on equity)
6. Describe 3 uses for each of the following financial statements: (14 points)

A. Balance Sheet
   from list of uses

B. Accrual Income Statement
   

C. Cash Flow Budget
   

USES OF A BALANCE SHEET

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4. Determine your true Cost of Production.

5. Provides a tool for evaluating operating efficiency on an economic basis.

6. A knowledge of New Income is crucial for analyzing Investment Decisions and Capital Debt repayment capacity.

7. Can be used in conjunction with the Balance Sheet to determine how much of the change in financial position is due to Reinvested Earnings (Losses) and how much is due to Inflation (Deflation).
7. What is the primary benefit of using the DuPont Model? (5 points)
   - To see interrelationships between financial measures
   - To look at the effect of changing one of the measures

   2½ points each

8. If a business is using borrowed money profitably, will the rate of return on equity (ROE) be higher or lower than the rate of return on assets (ROA) and why? (6 points)
   - ROE would be higher than ROA 3 points
   - If ROA were higher than ROE it would mean equity capital was subsidizing borrowed capital
   - If borrowed capital is being used profitably, it means the return on borrowed capital exceeds its cost and the excess return are added to the return on equity

9. The discussion of financial statement analysis was built around 5 financial criteria used to evaluate a business's financial position and performance. List them (you don't need to define). (10 points)

   2 points each

   liquidity
   solvency
   profitability
   repayment capacity
   financial efficiency
10. Ten different financial measures are listed below. Indicate for each whether it is a liquidity (L), solvency (S), profitability (P), repayment capacity (RC), or financial efficiency (FE) measure. (15 points)

   | P  | 1. Operating Profit Margin Ratio |
   | L  | 2. Working Capital to Gross Income Ratio |
   | S  | 3. Debt to Asset Ratio |
   | P  | 4. Rate of Return on Equity |
   | FE | 5. Operating Expense Ratio |
   | FE | 6. Asset Turnover Ratio |
   | P  | 7. Rate of Return on Assets |
   | L  | 8. Cash Flow Coverage Ratio |
   | RC | 9. Term Debt Coverage Ratio |
   | RC | 10. Debt to Income Ratio |

1.5 points each
11. Use what you need from the information provided below and calculate both this farm’s cash basis and accrual adjusted net farm income for 2012. Show your work (20 points)

<table>
<thead>
<tr>
<th>Item</th>
<th>12/31/11</th>
<th>12/31/12</th>
<th>Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and checking balance</td>
<td>$100,000</td>
<td>$150,000</td>
<td>+$50,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>125,000</td>
<td>175,000</td>
<td>-100,000</td>
</tr>
<tr>
<td>Grain and feed inventory</td>
<td>600,000</td>
<td>500,000</td>
<td>-20,000</td>
</tr>
<tr>
<td>Prepaid rent</td>
<td>300,000</td>
<td>280,000</td>
<td>+10,000</td>
</tr>
<tr>
<td>Investment in growing crops</td>
<td>50,000</td>
<td>60,000</td>
<td>+10,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>700,000</td>
<td>750,000</td>
<td></td>
</tr>
<tr>
<td>Farm real estate</td>
<td>1,200,000</td>
<td>1,500,000</td>
<td></td>
</tr>
<tr>
<td>Account payable</td>
<td>80,000</td>
<td>80,000</td>
<td>0</td>
</tr>
<tr>
<td>Operating loan balance</td>
<td>200,000</td>
<td>250,000</td>
<td>+2000</td>
</tr>
<tr>
<td>Accrued real estate taxes</td>
<td>10,000</td>
<td>12,000</td>
<td>-2,000</td>
</tr>
<tr>
<td>Mortgage loan balance</td>
<td>400,000</td>
<td>350,000</td>
<td></td>
</tr>
</tbody>
</table>

2012 Crop sales                                                     | $1,500,000|
2012 Cash farm operating expenses                                   | 1,000,000 |
2012 Capital purchases                                              | 150,000   |
2012 Family living withdrawals                                      | 80,000    |
2012 Depreciation expense                                           | 75,000    |

\[
\begin{align*}
\text{net cash farm income} & = 1,500,000 - 1,000,000 - 75,000 \\
\text{accrual adjustments} & = 425,000 - 62,000 \\
\text{accrual adjusted net farm income} & = 363,000
\end{align*}
\]

-1 for arithmetic mistakes
-1.5 for including incorrect items
-1.5 for omitting correct items
-1 for wrong sign or income effect
Agricultural Economics 330  
Fall 2014  
Exam I

1. A business can be a) generating a positive cash flow and be unprofitable, b) be profitable but experiencing cash flow problems. For a) and b) give me 3 reasons/examples of how each statement can be true. (9 points)

   a) non-farm income
      building accounts payable
      borrowing or refinancing
      selling assets
      liquidating inventories
      receiving gifts or inheritances
      
   b) paying off debts
      paying accounts payable
      cash purchases of capital assets
      gifting cash
      building inventory
      building accounts receivable
      
2. What creates deferred taxes on current assets? (6 points)
   
   result from using one income accounting method for financial (managerial) reporting and another for tax reporting
   
   (due to difference in timing of income (revenue and expense) recognition)
3. Define the following financial criteria used to evaluate a business's financial position and performance, and give an example of 1 measure used to evaluate each criteria. Just name, you don't have to show formula. (15 points)

   a) Liquidity: the ability of the business to meet its financial obligations as they come due without disrupting the ongoing operation of the business.

   b) Profitability: the relationship of revenues and expenses - the extent to which the business is able to earn a profit from the use of available resources.

   c) Repayment capacity: the ability to service debt from farm and non-farm income.

   d) Solvency: borrowed capital relative to owner capital - the risk bearing ability of the ability to handle and adversity - the ability to cover all liabilities if all assets were liquidated.

   e) Financial efficiency: input-output efficiency in financial (economic) terms - the efficiency with which a business uses its resources.

4. I discussed 5 ways that financial analysis could help improve a farm owner's/manager's decision making. What were 3 of them? (6 points)

   2 pt:
   - identify and learn from past mistakes
   - make fewer mistakes
   - take more timely and appropriate action to correct problems
   - identify strengths and weaknesses
   - spot opportunities
5. What are some (3) of the advantages of using accrual adjusted net farm income versus cash basis income accounting to measure the farm business's performance? (6 points)

- Accruals show the income of what the business actually generated during the period and what it cost.
- Accruals give an earlier indication of whether the business is improving or starting to experience problems.
- Accruals give a more accurate accounting of the basis for the change in earned net worth.

6. When conducting financial analysis, multiple perspectives on the measures of improve the analysis. Give 3 different perspectives or ways of looking at a firm’s financial measures that can be used to gain greater insight. (6 points)

- Trends
- Variability
- Projections versus past performance
- Compare actual results to projections
- Comparisons to peers
- Benchmarks
- Industry standards
- Operator's objectives

7. If a business is using borrowed money profitably, will the rate of return (ROE) be higher or lower than its rate of return on assets (ROA) and why? (5 points)

- ROE will be higher than ROA

- Either
  - if ROA were higher than ROA it would mean equity capital was subsidizing borrowed capital
  - if borrowed capital is being used profitably, it means the returns on borrowed capital exceed its cost and the excess returns supplement the return on equity
8. What do you get if you multiply of business’s operating profit margin by its asset turnover ratio? (5 points)

\[ \text{ROA} \]

9. What is the primary reason for having a balance sheet that shows net worth (owner equity) on both a cost and a market value basis? (6 points)

To determine how much of net worth is earned/contributed capital and how much is due to asset revaluation.

10. How can the cash flow budget be used for the following? (6 points)

a) As a financial control tool

Compare budgeted to actual performances and focus on differences to initiate analysis and corrective actions.

b) For analyzing the impact of risk(uncertainty)

Look at the impact of different outcomes on cash flows.

c) As an investment analysis tool

Look at projected cash flows with the operation as is and then compare it to what it would look like if the investment were made.
11. Describe 3 uses for each of the following statements. (12 points)

a) Balance Sheet

b) Accrual Adjusted Income Statement

2 pts 6
See attached list of uses of $5 + $5
12. Use what you need from the information provided below and calculate both this farm's accrual adjusted net farm income for 2013. Show your work (18 points)

<table>
<thead>
<tr>
<th></th>
<th>12/31/12</th>
<th>12/31/13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checking balance</td>
<td>$200,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>150,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Grain and feed inventory</td>
<td>1,300,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Investment in growing crops</td>
<td>30,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>750,000</td>
<td>850,000</td>
</tr>
<tr>
<td>Farm real estate</td>
<td>12,800,000</td>
<td>14,080,000</td>
</tr>
<tr>
<td>Account payable</td>
<td>100,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Operating loan balance</td>
<td>500,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>200,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Accrued real estate taxes</td>
<td>25,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Supplies inventory</td>
<td>50,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Mortgage loan balance</td>
<td>3,840,000</td>
<td>3,600,000</td>
</tr>
</tbody>
</table>

2013 Cash grain sales                          $2,400,000
2013 Cash farm operating expenses            $1,600,000
2013 Family living withdrawals             $90,000
2013 Capital purchases                      $200,000
2013 Depreciation expense                   $150,000
2013 Principal payment on farm mortgage     $240,000
2013 Interest paid                          $205,000
2013 Increase in value of farmland          $1,280,000

\[
\begin{array}{c|c|c|c|c}
2,400,000 & 1,600,000 & 150,000 & 200,000 & 1,200,000 & 1,290,000 & 10,000 & 40,000 & 30,000 & 75,000 & 25,000 & 20,000 & 2,000 & 30,000 & 33,000 \\
\hline
\end{array}
\]

\[\text{ANFI} \quad 478,000\]

\[\text{ANFS} \quad \frac{445,000}{.33,000}\]
USES OF A BALANCE SHEET

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